BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
W. T . GRANT COMPANY)

Appearances:

For Appellant : S. Nielson and Douglas Erskine, Attorneys at Law

For Respondent: W.M. Walsh, Assistant Franchise Tax Commissioner and Mark Scholtz, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chapter13, Statutes of 1929, as amended) from the action of the Franchise Tax. Commissioner on the protests of W. T. Grant Company to proposed assessments of additional tax in the amounts of $5,310.74, $3,152.00 and $2,302.60 for the taxable years ended January 31, 1939, 1940 and 1941, respectively.

Appellant is a Delaware corporation engaged in the business of operating some 500 retail department stores throughout the United States, 10 of which are located in California. During the taxable years in question its stores here were operated by a Massachusetts corporation of the same name which, on February 1, 1941, was dissolved, its properties and business being absorbed entirely by its parent, the Appellant, which assumed full responsibility for the taxes here in controversy. For convenience we shall refer to the activities of the Massachusetts corporation as those of the Appellant.

Control and management of all its operations are concentrated in Appellant's main offices in New York City, where central buying, merchandising, sales promotion, advertising., display, traffic and accounting departments are maintained. With the exception of imported merchandise, orders for goods contracted for by the central office are placed by the individual stores directly with the suppliers, discretion as to quantities required being left entirely to them. Suppliers biil the individual stores at the contract price and upon receipt of the merchandise, the stores check the invoices and forward them to the central office for payment. Imported merchandise, which constitutes less than 1% of Appellant's annual purchases, is warehoused by it and distributed upon requisition by the stores which are billed therefor at a price equal to cost plus the estimated cost of handling.

In addition to the sums derived from its buying and merchandising operations, Appellant received miscellaneous income in such forms as rents on subleased properties, commissions on sales of leased departments, dividends and interest.

In its franchise tax returns for the years in question Appellant allocated its miscellaneous income according to source and computed its income from its merchandising operations in this State by deducting from gross operating profit (California sales less cost of goods sold) expenses incurred directly in the realization of that profit, such expenses including transportation of goods sold here, local rents, payrolls, advertising, utilities, taxes, repairs, and insurance, and that proportion of central office and district supervisory expense which Appellant's California sales bore to its total sales everywhere and in its particular district, respectively.

The Commissioner recomputed Appellant's liability by applying a three factor formula under Section 10 of the Bank and Corporation Franchise Tax Act. A percentage arrived at by averaging the ratios of California payroll, property and sales to the total of each of those items was applied to the Appellant's total net income from its buying and selling activities, the results of this computation, as compared with those of the Appellant's method, being as follows:

	Net Income attributed to California	
Income Year	By Appellant	By Commissioner
1938	$ 2,870.01	$135,276.88
1939	44,545.89	126,420.96
1940	108,934.22	167,292.23

The substance of Commissioner's position is that Appellant's business is a unitary enterprise, that he is entitled to allocate an appropriate share of its income to California by the application of a formula, that the formula applied enjoys judicial sanction and that it may not be impeached by the use of a separate accounting, however sound. He cites Butler Bros. v. McColgan, 315 U. S. 501, in support of this position.

Appellant does not deny that its business is a unitary one, nor does it attack the Commissioner's right to employ a formula reasonably calculated to attribute to California a fair share of its unitary income. It contends, however, that the particular formula adopted by the Commissioner, when viewed in the light of the conditions that affect the operation of its business in California, produces an arbitrary and unreasonable result and operates to include within the measure of the California tax net income derived from sources outside this State, in violation of the terms of the tax act, Article I, Section 13 of the California Constitution and the Fourteenth Amendment to the Constitution of the United States. Hans Rees' Sons v. North Carolina, 203

U. S. 123, is the principal authority cited by Appellant as respects the requirement of the Fourteenth Amendment that the tax be measured only by income derived from California sources.

In support of its position Appellant attempts to demonstrate by the use of separate accounts for California and other States that its California stores have higher costs of transportation, higher wages, higher advertising outlays, higher taxes and other costs per dollar of sales than its stores elsewhere, and that a dollar of sales in California, accordingly, produces less profit than a dollar of sales in any other state in which it operates and less than the average profit realized on a dollar of sales for its system considered as a whole.

Observing the advice of Mr. Justice Douglas in the Butler Brothers case, Appellant attempts from this point to discredit the factors used in Commissioner's formula individually. Sales are said to be an inappropriate measure because, as Appellant has" attempted to show, the higher local costs distort their rsletion to net income here as compared with other states. By virtue of our minimum wage statutes, salaries and wages are said to be higher in California than in all the other states, taken as a whole, in which Appellant did business, but California payroll expenditures are said not to create a higher dollar volume of sales than equivalent expenditures elsewhere. As to the property factor, Appellant points out that 80% of its tangible property consists of merchandise which, it contends, because of higher California selling oosts, does not have the income producing value here that it does elsewhere, As to Appellant's remaining physical assets, which consist entirely of furniture and fixtures, it is argued that because of the high depreciation sustained on the equipment in its Eastern stores, as compared with that suffered on' the relatively new equipment in the California stores of Appellant, its value has little or no relation to the volume of business done.

It has been recognized that "A division of revenue and costs in accordance with State lines can never be made for a unitary business with more than approximate correctness." Norfolk and Western Railway v. North Carolina, 297 U.S. 682, 684; International Harvester Co. v. Evatt, 329 U.S. 416. In a line of decisions including Adams Express Company v. Ohio, 165 U.S. 194, and Butler Bros. v. McColgan, supra, the Supreme Court of the United States has held that the use of an allocation formula fairly calculated to assign to a state its fair share of the intangible value or net income of a unitary enterprise is proper and that a formula not arbitrary on its face will not be upset in the absence of a clear showing that its application in a particular case will effect a projection of the taxing power of the State to subjects or activity beyond its borders.

Appellant has attempted here to impeach the allocation formula employed by the Commissioner. It has endeavored to overcome the prima facie validity of the Commissioner's formula by attempting to show that income of the Appellant earned outside California was wrongfully included in the measure of its franchise tax liability and has offered us an alternative basis of

computation: The Commissioner insists on the other hand, that Appellant has not discharged its burden of proof',

We are of the opinion that the position of the Commissioner must be sustained. Appellant states that:

> "The crucial point...is that selling expenses in California, wages and salaries paid in California, and values of tangible property in California, the three factors used in Respondent's formula, are each materially higher per dollar of income than they are. in most other states-and than they are in Appellant'8 general experience. Hence it is a mathematical certainty that. the formula must assign to California more income that California operations earn." (Appellant's Supplemental Memorandum, p. 1)

The real point of inquiry, however, is not Appellant's per unit profit on sales in California, for it is not the net income from its California merchandising operations considered separately which we seek to ascertain. Appellant conducts a. unitary enterprise and as such each of its units is a part of an integrated system. What we want to know is how its activities in California bear upon the success of the organization considered as a whole. Appellant has attempted to bring us to the answer by use of what is essentially a separate accounting, which is a means unsuited to the end in view. Butler Brothers v. McColgan supra; Edison California Stores, Inc. v. McColgan 30 Cal. 2d 472. The whole object of a unified merchandising organization is to capture the advantages inherent in mass buying and centralized services and control. In this aspect, the expansion of markets anywhere makes a contribution to economies affected elsewhere, and makes possible the reduction of per unit cost of merchandise throughout the entire system. A local per unit loss, much less a lower per unit profit in local markets, is not inconsistent with improved net profits for the unitary business taken as a whole. This the United States Supreme Court expressly recognized in the Butler Brothers case where the taxpayer, through recognized accounting procedure, 'showed a net loss on its books from its California operations, though the application of the allocation formula resulted in apportioning to this State a share of the company's total net profit from all its operation. In Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472, 480-481, the Court said

> ". ..when the business is not separate, and is an integral part of a larger and unitary system, the separate accounting is inadequate and unsatisfactory in ascertaining the true result of the activities and values attributable to that business."

We think that this applies to the present situation and that there is no precise interrelation between the net profit realized on the Appellant's California sales as determined by separate accounting and the contribution made to the net income of the unitary business by the Appellant's California activities.

It follows, therefore, that the attempted computation of California net income on the basis of the separate accounting employed by the Appellant is inappropriate to the task of assigning to this State the share of its net income for the years in question properly attributable to its activities here.

Accordingly, we are not persuaded that the Appellant's showing based upon its separate accounting demonstrates that the allocation formula applied by the Commissioner is arbitrary or unreasonable. The authorities reviewed establish clearly that a taxpayer whose activities are spread over many states may be treated as a single entity for purposes of taxation and its local expenditures and investment may be viewed in terms of their contribution, not to local selling profit, but to the success of the organic whole. Appellant has made no attempt to show the extent of that contribution, and we cannot say in the absence of evidence on that matter that the application of Commissioner's formula results in an excessive tax.

We must conclude, therefore, that Appellant has not established that the Commissioner's determination results in the taxation of income not fairly attributable to this State in violation of the Bank and Corporation Franchise Tax Act, the California Constitution or the Fourteenth Amendment to the Constitution of the United States.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25 of the Bank and Corporation Franchise Tax Act, that the action of Chas. J. McColgan, Franchise Tax Commissioner, on the protests of W. T. Grant Company to proposed assessments of additional tax in the amounts of $5,310.74, $3,152.00 and $2,302.60 for the taxable years ended January 31, 1939, 1940 and 1941, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 15th day of December, 1948, by the State Board of Equalization.

Wm. G. Bonelli, Chairman
J. H. Quinn, Member
J. L. Seawell, Member
Geo. R. Reilly, Member
Thomas H. Kuchel, Member

ATTEST: Dixwell L. Pierce, Secretary